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Rising interest rates change strategies for investors, borrowers

ON INVESTING
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Stock and bond market investors watch with trepidation as the Federal Reserve Board determines how much to raise interest rates this year. The Fed has already taken short-term interest rates from roughly zero percent to a target of 1.50 percent to 1.75 percent, and promises further hikes throughout 2018.

While the Fed's forecasts are not always prescient, economists and investors seem to be taking them at their word. The futures market is pricing in at least two more Fed hikes this year, with a solid probability of a third. And, surveys of economists mostly point to higher rates as well.

This has caused volatility for stocks and bonds. Stocks have gyrated wildly since late January, owing to a host of concerns, not least of which is the impact higher interest rates could have on already high stock valuations.

Bonds have fallen around 2 percent year to date, as rising interest rates have a direct negative impact on bond prices. Further moves by the Fed could lead to additional turmoil for both stocks and bonds.

There is one class of investor, however, cheering for a more aggressive Fed: those holding cash in the form of CDs, interest-bearing bank accounts, or other short-term instruments.

It might seem foolhardy to hold cash these days, as returns for many money market funds have literally been zero for the past several years. If you consider the impact of inflation, those holding cash have actually lost money through reduced purchasing power. But, the comfort of cash, particularly when stocks and bonds gyrate wildly, is hard to replace.

Stocks, as measured by the S&P 500, have produced annualized returns of over 10 percent since 1926. Bonds have returned 5.1 percent on the same basis, and cash, as measured by one-month Treasury bills, has returned 3.3 percent. Even with its lower returns, cash has historically generated enough yield to keep ahead of inflation, without having to worry about losing money. Stocks and bonds have both experienced significant periods of loss, but cash returns have rarely dipped below zero, and only modestly when it has happened.

Far from cash's historic return of 3.3 percent, the Fed reduced short-term interest rates to around zero in response to the Great Recession in 2007 and 2008. Interestingly, at the same time, some European nations actually reduced rates to negative levels, which resulted in an odd scenario where you actually had to pay to loan your money to banks and others. The low rate environment in the U.S. allowed for a greater flow of money, which, the Fed hoped, would lead to increased economic activity, and a faster recovery. However, it also had the effect of harming retirees and other conservative investors who are not willing or able to take investment risk, but who also depend on their assets to meet their living expenses. Returns on safe investments like money market funds, short-term CDs, and savings accounts have hovered near zero ever since.

Frustratingly, as short-term interest rates have risen over the past year, rates on money market funds and CDs have remained stubbornly low. After years of reducing or waiving fees on some of these products, banks and brokerage firms seem to be enjoying a greater profit margin, without sharing it with their accountholders.

Banks take deposits in order to make loans. They profit by paying less interest on deposits than they earn on their loans. As that gap widens, bank profits expand. On the other hand, if banks are too stingy with depositors, they eventually take their money elsewhere, impairing banks' ability to make new loans. However, as many banks today have more deposits than they can lend out, they see no need to significantly increase the rate they pay depositors.

Indeed, while the Fed has raised short-term interest rates 1.50 percent since it started this round of rate hikes, CD rates have only increased by 0.27 percent. Money market account deposit rates are currently only 0.05 percent higher. Clearly, banks feel no pressure to improve the returns to accountholders.

What's a conservative investor to do? There are a few strategies to consider.

One approach is to ladder a portfolio of CDs. This involves buying a number of CDs with various maturities, say every 6 months. That way, as rates rise, maturing CDs may be reinvested at higher rates further out in time. It takes a bit of work to manage this, but it could help increase returns versus holding a single CD.

The second is to replace cash held for emergency purposes with a home equity line of credit. Many credit unions offer HELOCS for up to $50,000 with no application fees. They do not cost anything unless you draw on them, making them a solid replacement for an emergency fund, assuming you don't have emergencies very often. With this source of liquidity in place, cash balances may be invested more productively, even if only in short-term bonds.

Note, however, that this strategy will be less effective as interest rates rise, as rates on HELOCs are generally variable. Additionally, with the new tax code, deducting interest on HELOCs is no longer available, also making this strategy less attractive going forward.

Another approach is to wait for returns on cash investments to rise. There is evidence that is starting to happen. CD rates have already started to climb higher, albeit modestly. And, interest paid on bank deposits has risen lately, but only for business accounts and affluent customers. If the Fed continues to raise short-term rates, we would not be surprised to see banks finally share their largess a bit more, even with rank-and-file accountholders.

Finally, it may make sense to consider online accounts. Increasingly, the necessity of transacting business by walking into a bank branch is becoming obsolete. Rather than stick to the rates paid by your local bank, you may be able to find higher rates with online bank accounts. Credit unions often offer higher rates as well. Bankrate maintains a website that compares rates for CDs, savings accounts, money market accounts and others.

Even with interest rates on the rise, it will likely be some time until cash returns resemble "the good old days." A little footwork now could increase your return while you wait.

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